

# Income Taxation - Deductability of Advertising Expenditures

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defendant; (3) It must not have been due to any voluntary action of contribution on the part of the plaintiff."<sup>17</sup>

The difficulty of proof arises chiefly with respect to the first element. The passenger in the ordinary case, being ignorant of the chain of circumstances producing the injury, is at an obvious disadvantage in attempting to prove that such circumstances exclude any reasonable explanation of the unusual occurrence other than the carrier's negligence. Yet, if the passenger is prohibited from invoking the doctrine until he has excluded non-negligent explanations, a strict reading of the traditional rule of *res ipsa* would almost invariably forbid the use of the doctrine in the average passenger-carrier situation. In its strict traditional sense, *res ipsa* relieves a plaintiff from showing specifically that defendant's negligence caused the injury, but substitutes an obligation of proving that nothing else caused it. It is indeed the rare case wherein a plaintiff may draw any great solace from the substitution; and by the same token, it is indeed the rare case in which the doctrine, under strict application of its traditional requirements, may be invoked at all.

One thing, however, may be stated as obvious: if a strict adherence to traditional prerequisites of *res ipsa* is continued, then certainly the inference permitted when the doctrine is invoked successfully should be raised to the full dignity of a presumption. The doctrine is practically valueless when it first requires plaintiff to exclude, by proof of circumstances, all reasonable explanations of the injury other than defendant's negligent conduct, yet rules that a mere permissible inference is the most that can result.

The writer's conclusion, therefore, is that some liberalization of the traditional requirements of *res ipsa loquitur* is necessary before the dictum of Justice Currie in the principal case can be freely accepted, and *res ipsa* applied in any but the most isolated passenger-carrier cases. At the same time, it would appear that the passenger's problem of proof would be eased to a greater extent by such liberalization than by the Louisiana rule shifting the burden of proof to the carrier.

RALPH E. ANFANG

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#### Income Taxation—Deductibility of Advertising Expenditures—

Taxpayer corporation, engaged in the business of designing, manufacturing and installing laboratory equipment, printed and distributed catalogs to its representatives to be used as reference books in making sales of equipment. In the years of 1944, 1945, and 1946 the taxpayer incurred costs as a result of printing a new catalog which was pub-

<sup>17</sup> PROSSER, TORTS, §43, p. 295 (1941).

lished September 1, 1946. The taxpayer deducted these costs on its tax returns as current business expenses for the years in which the expenditures were incurred. The Commissioner, sustained by the Tax Court, disallowed the deductions and determined that the cost of the catalogs was recoverable only through amortization over a period of five years, the useful life of the catalogs, to begin at the date of publication. *Held*: Reversed. An expense such as advertising cannot be capitalized in the absence of evidence showing with reasonable certainty the benefits resulting in future years from the expenditure. *E. H. Sheldon & Co. v. Commissioner of Internal Revenue*, 214 F. 2d 655 (6 Cir. 1954)

Under section 162 of the Internal Revenue Code of 1954,<sup>1</sup> a deduction is allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Assuming the existence of a trade or business, advertising is generally within section 162, and hence deductible. The Regulations issued under the 1939 Code indicate that normally advertising expense satisfies the requirements of this section:<sup>2</sup>

"Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business\*\*\*. Among the items included in business expenses are \*\*\* advertising and other selling expenses\*\*\*."

and prior decisions are in accord.<sup>3</sup>

Although an unusually large expenditure in a taxable year may still meet the requirements of ordinary and necessary in section 162,<sup>4</sup> difficulty arises where all or a portion of the expenditure bears some of the characteristics of an investment rather than an expense. If the expenditure is a capital investment, then it is not deductible as an ordinary and necessary business expense.<sup>5</sup>

Section 263 of the Code entitled "Capital Expenditures" provides that no deduction shall be allowed for any amounts paid out for new buildings or for improvements which increase the value of any property.<sup>6</sup> The only reference to advertising expenses is in subsection (b) which relates to a specialized treatment of expenditures in reference to the excess profits tax.<sup>7</sup> It is apparent on its face that section 263

<sup>1</sup> 68A STAT. 45, 46 (1954).

<sup>2</sup> Treas. Reg. 118, §39.23(a)-1.

<sup>3</sup> *Transamerican Corp. v. U.S.*, 107 Ct. Cl. 177, 65 F. Supp. 470 (1946); *Julia Dahl et al, Exec.*, 24 B.T.A. 1167 (1931); *Hennepin Holding Co.*, 23 B.T.A. 119 (1931); *B. F. Boyer Co.*, 4 B.T.A. 180 (1926); *Edwin C. Brandenburg*, 4 B.T.A. 108 (1926); *Ray Crowler et al.*, 19 T.C. 329 (1952).

<sup>4</sup> *Appeal of First National Bank of St. Louis*, 3 B.T.A. 807 (1926).

<sup>5</sup> *Alling & Cory Co.*, 7 B.T.A. 574 (1927).

<sup>6</sup> INT. REV. CODE §263.

<sup>7</sup> INT. REV. CODE §263(b): "EXPENDITURES FOR ADVERTISING AND GOOD WILL.—If

does not force the capitalization of expenditures for advertising. What, then, is the relationship of the problem illustrated in the *Sheldon* case and the Internal Revenue Code? The true nature of the problem is one of tax accounting. Under section 446(b) the Commissioner is given the power to compute the taxable income of a taxpayer in order to clearly reflect income.<sup>8</sup> The *Sheldon* case is but an illustration of this power in operation, for it is the Commissioner who is insisting that the advertising expenditure be capitalized.

If an expenditure for advertising is capitalized, several possibilities present themselves, depending upon the factual pattern of each case. As a consequence of the expenditure a depreciable asset may have been acquired. Should this in fact be the situation, then it would seem that the cost of such asset may be recovered through depreciation deductions under section 167<sup>9</sup> even though the asset is personal property.<sup>10</sup> The effect of this is to allocate to the income produced over a period of several taxable years a corresponding proportionate share of the advertising cost of producing that income. Closely related in tax effect, a second situation may present itself where there is a definite relation between the expenditure and an item of income, such as the purchase of one or more advertising contracts having a life of more than one year. It has been held proper in such a case to capitalize the expenditure and prorate it over the life of the contracts.<sup>11</sup> This is analogous to the deferred expense approach utilized to allocate the prepaid cost of fire insurance over the life of the contract.<sup>12</sup> Still one other potential pattern remains. Where the object of the advertising is primarily some promotional scheme to bring the taxpayer's product before the public eye or to impress upon the public mind a trade name or slogan, then capitalization of such an expenditure would result in an intangible asset, such as goodwill or trade name. The effect of this is to hold dormant the expenditure at least until the business is sold or terminated in some way, since goodwill does not lend itself to allowances for depreciation.<sup>13</sup>

a corporation has, for the purpose of computing its excess profits tax credit under chapter 2E or sub-chapter D of chapter 1 of the Internal Revenue Code of 1939 claimed the benefits of the election provided in section 733 or section 451 of such code, as the case may be, no deduction shall be allowable under section 162 to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733 or section 451 of such code, as the case may be, may be regarded as capital investments."

<sup>8</sup> INT. REV. CODE §446(b).

<sup>9</sup> INT. REV. CODE §167.

<sup>10</sup> Treas. Reg. 118, §39.23(1)-2.

<sup>11</sup> *United Profit Sharing Corp. v. U.S.*, 66 Ct. Cl. 171 (1928).

<sup>12</sup> *Commissioner v. Boylston Market Ass'n.*, 131 F.2d 966 (1st Cir. 1942); *George S. Stephenson*, 37 B.T.A. 1117 (1938).

<sup>13</sup> Treas. Reg. 118, §39.23(1)-3. *Bills Bros. Memorial Corp.*, 7 B.T.A. 1182 (1927); *Bryson Jones*, 17 B.T.A. 1213 (1929); *U.S. Alcohol Co.*, 42 B.T.A. 1323, 1346 (1940), *aff'd* on this issue, 137 F.2d 511 (2nd Cir. 1943).

The *Sheldon* case, now under consideration, afforded the Circuit Court of Appeals an opportunity of explaining precisely what test is to be used in determining whether an expenditure relating to advertising is to be capitalized. The court proceeded to analyze the fact situation presented by applying concepts reaching back to 1926 as exemplified in a Board of Tax Appeals decision, *Appeal of Northwestern Yeast Co.*<sup>14</sup>. In that case a corporation expended large sums of money in an advertising and promotion campaign. Although the petitioner kept records showing the allocation of the expenditure, it failed to show the proper segregation and allocation between current expense and capital investment. In refusing to allow the petitioner to capitalize a part of the expenditure, the court said:<sup>15</sup>

Generally and theoretically \*\*\* it is safe to say that some part of the cost of a campaign or system of promotion may be of permanent significance and may be regarded as a capital investment rather than a deductible expense. But how far in a given case the recognition of this doctrine may require the capitalization of some expenditures and the charging off of others is hard to say. Clearly when the question is submitted for judicial consideration, it may not be answered *ab inconvenienti* by an arbitrary rule.

The effect of this case was that the Board of Tax Appeals had admitted that some part of advertising expenditures for promotional plans represents a capital investment in the future and that the other part is a current expense. The court left the burden of proving that segregation and allocation on the one asserting the propriety of capitalizing a part of the expenditure. Thus, while admitting the theoretical possibility, the whispered undertone of the decision was that there was a practical impossibility of sustaining such a burden of proof. Other subsequent cases have followed this decision still insisting on the theoretical possibility.<sup>16</sup>

In 1946, the Tax Court in *X-Pando Corporation*<sup>17</sup> explained and further limited the theoretical possibility concept of the *Northwestern Yeast Co.* regime.<sup>18</sup> X-Pando Corporation underwent a shift in ownership in 1937. One of the results of the new blood in the business was the adoption of a promotional plan which was to have a duration of about three years. The officers of the petitioner were aware that

<sup>14</sup> 5 B.T.A. 232 (1926).

<sup>15</sup> *Ibid.*, at 237.

<sup>16</sup> *Three-In-One Oil Co. v. U.S.*, 35 F.2d 987, 68 Ct. Cl. 518 (1929); *Morris Coal Co. v. Commissioner*, 48 F.2d 810 (6th Cir. 1931); *Houston National Gas Corp. v. Commissioner*, 90 F.2d 814 (4th Cir. 1937); *Richmond Hosiery Mills*, 6 B.T.A. 1247, aff'd 29 F.2d 262 (5th Cir. 1928); *Mead Cycle Co.*, 10 B.T.A. 887 (1928); *Rome Iron Mills, Inc.*, 10 B.T.A. 1202 (1928); *Conrad & Co.*, 13 B.T.A. 1332 (1928); *George W. Caswell Co.*, 14 B.T.A. 15 (1928).

<sup>17</sup> 7 T.C. 48 (1946).

<sup>18</sup> *Supra*, notes 14 and 16.

some of the money expended was to reap current income and some future income. A special account was set up as an asset to which a fixed percentage of the expenditures were charged; the remainder of the expenditure was treated as a current business expense. No contention was made that any tangible property was acquired except for some plates used in the preparation of advertising circulars. The petitioner attempted to amortize the "Business Development Account" on the basis of a five-year useful life. In deciding that the petitioner could not properly amortize the expenditure, the Tax Court emphasized that, with the exception of the *Colonial Ice Cream Co.*<sup>19</sup> and the *F. E. Booth*<sup>20</sup> cases, the cases following the *Northwestern Yeast Co.*<sup>21</sup> decision all dealt with the possibility of allowing the taxpayers to include a portion of the advertising expenditure in their invested capital and did not involve the issue of amortization and deduction from gross income in future years.

The conclusion of the *X-Pando* decision is that where large sums have been expended for advertising and either the taxpayer or the Commissioner asserts that all or a portion of such expenditure should be capitalized and amortized on the basis of a useful life, the test to be used is twofold in nature: (1) can the party maintaining the position sustain the burden of proving to a reasonable certainty the proper segregation and allocation between current expense and capital expenditure, and (2) is there some justification for claiming the deductions in subsequent years. The court states:<sup>22</sup>

"If we were to admit here petitioner's theory that because it anticipated no current return on some portion of its expenditures, but expected benefits therefrom in later years, that portion has the quality of a capital investment, and if we were to further admit that petitioner has succeeded, where so many others have failed, in establishing by proof the proper proportion which the capital items bore to the total expenditures, we would still be required to find statutory authority for the de-

<sup>19</sup> 7 B.T.A. 154 (1927). The taxpayer had paid out substantial sums for organization and advertising expenses and for the purchase of certain ice cream cabinets. It attempted to treat the sum as a deferred expense, to be spread over three years. The Board of Tax Appeals concluded that the amount spent for ice cream cabinets was to be depreciable over the three-year life of the cabinets, and that the organization expenses could be capitalized. In reference to the advertising expense, there was recognition that the benefits received would extend over a period of years, but the board felt that it was impossible to determine the extent of the expenditures which were capital in nature.

<sup>20</sup> 21 B.T.A. 148 (1930). The taxpayer spent large sums of money in a promotional campaign to increase the sale of canned sardines. It attempted to spread the total cost of \$105,000 over a period of several years. The Board of Tax Appeals held that the deduction of advertising expenses sought in later years should not be allowed because it was impossible to segregate the capital from the current expenses.

<sup>21</sup> *Supra*, note 14.

<sup>22</sup> 7 T.C. at 53.

ductions in some later years, since deductions are a matter of legislative grace."

The Tax Court in the *Sheldon* case reconciled its decision that the total expenditure should be capitalized by invoking the principle that:<sup>24</sup>

"\*\*\*if a taxpayer purchases an asset having a useful life of several years and uses it to advertise its products over several years, its cost is not deductible as an expense of the first year."

The decisive factor in the Tax Court decision is the recognition that the taxpayer actually purchased an asset, namely trade catalogs. Once this is established there is really no need to search for a proper segregation and allocation between current expense and capital expenditure. This very segregation is in fact accomplished when a useful life is attributed to the asset and a reasonable amount is allowed for depreciation. Other cases have handled the problem in the same manner. For instance, in *Alling & Cory Co.*<sup>25</sup> the expenditure was capitalized when certain sample cabinets and samples were found to have a useful life and value as an income-producing factor extending beyond the tax year in which the items were purchased; in *Liberty Insurance Bank*,<sup>26</sup> savings banks used as advertising novelties were held to be capital expenditures and the deductions were spread over a four-year period; and in *Peninsular State Bank of Detroit*,<sup>27</sup> small auxiliary safes loaned to depositors to accumulate savings were held to be capital expenditures.

Invoking the statutory power of the Circuit Court of Appeals to review findings of fact of the Tax Court if clearly erroneous,<sup>28</sup> the circuit court in the *Sheldon* case completely ignores the fact that the total expenditure in controversy resulted in trade catalogs, and applies the subjective criteria originating in 1926 in *Appeal of Northwestern Yeast Co.* In the opinion of the writer the evidence presented in the Tax Court should not have been overlooked. The catalogs were clearly tangible assets. They did not affect the income of the corporation until after the publication date on September 1, 1946. Certainly it would not be clearly reflecting income to allow the amounts spent in 1944, 1945, and early 1946 to be deducted as ordinary and necessary business expenses when the money expended had as yet produced no income. The evidence also established that as a matter of fact the catalogs did benefit the business for at least five years after the

<sup>23</sup> 19 T.C. 481 (1952).

<sup>24</sup> *Ibid.*, at 485.

<sup>25</sup> 7 B.T.A. 574 (1927).

<sup>26</sup> 14 B.T.A. 1428 (1929), rev'd on another issue, 59 F.2d 320 (6th Cir. 1932).

<sup>27</sup> 3 B.T.A. 399 (1927).

<sup>28</sup> INT. REV. CODE §7482(a).

publication date. In the face of this, the Commissioner's determination that the catalogs had a useful life of five years is not unreasonable. It is respectfully submitted that the Tax Court decision in the *Sheldon* case is the more realistic approach to the issue. The position of the Tax Court should be adhered to where the advertising expenditure results in a tangible asset, whereas that of the Circuit Court of Appeals should be restricted in its application to cases where some intangible asset is acquired.

RICHARD J. ASH

**Statute of Frauds—The Effect of Promissory Estoppel**—Plaintiff purchased a home next to the vacant property of the defendant. The house was of a modern design and of a functional nature. It was constructed at such a place so as to take advantage of a "terrific" view to the south and west. Before purchasing the dwelling, however, plaintiff spoke to the defendant and they reached an oral agreement as to the approximate location of defendant's house on the adjoining property when constructed. The defendant assured the plaintiff that he would not interfere with plaintiff's view by any building. After plaintiff bought the property, defendant started to construct a house inconsistent with the oral agreement and which would interfere with plaintiff's view of the country side. Plaintiff brings this suit to enjoin the defendant from building any structure which ignores the oral agreement as to view.<sup>1</sup> Defendant defends upon the Statute of Frauds. *Held*: The defendant, his heirs, and assigns and any subsequent owners of defendant's property shall be permanently prohibited from constructing any building which will interfere with the view from the house of the plaintiff or his successors until the termination of the use of the view. *Miller v. Lawlor*, 66 N.W. 2d. 267 (Iowa, 1953).

This case presents a somewhat unusual problem in the fact that the interest contracted for is a nonpossessory one.<sup>2</sup> Consequently the usual incidents of "part performance" in the familiar sense of the doctrine are absent. There is no contemplated entry by the grantee into possession, nor is there any possibility of a substantial improvement by the grantee of the subject lands. Either or both such circum-

<sup>1</sup> Plaintiff in an attempt to avoid the Statute of Frauds relied upon section 622.23 of the Iowa code which reads as follows: "Exception: The provisions of subsection 3 of section 622.32 do not apply where the purchase money . . . has been received by the vendor, or when the vendee, with the actual or implied consent of the vendor, has taken and held possession of premises under or by virtue of the contract, or when there is any other circumstances which, by the law heretofore in force, would have taken the case out of the statute of frauds." IOWA CODE (1950) I.C.A.

<sup>2</sup> "There can be no seizin of an incorporeal hereditament and it can not be the subject of entry or possession. 'It lyeth in grant, and not in livery.'" *The City of Racine v. Crotsenberg*, 61 Wis. 481, 21 N.W. 520 (1884); For a statement on the general subject see 2 AMERICAN LAW OF PROPERTY §8.16 (1952).